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Iraq-Italy: Repercussions of the BNL-Atlanta Scandal

Summary

The revelation that a US branch of an Italian bank, Banca Nazionale del Lavoro (BNL), granted more than $3 billion in unauthorized letters of credit to Iraq has had wide-ranging repercussions for Iraq and Italy. For Iraq, public disclosure that it used some of the credits to acquire military-related technology has impeded procurement efforts, and the suspension of BNL credits has slowed civilian reconstruction and development projects. For Italy, the BNL scandal has cast at least a temporary shadow on Prime Minister Andreotti's new government, raised questions about public-sector enterprises, and reopened the issue of privatization. [redacted]

The affair is unlikely to have a major impact on Iraqi military procurement efforts, but cash-short Baghdad probably will have to postpone plans for some civilian projects. The loss of BNL financing and, more important, any reduction in US agricultural credit guarantees because of negative publicity about the scandal probably would damage US-Iraqi commercial ties. For Iraq's part, however, the strain in political relations is likely to be short-lived, particularly if Baghdad believes US credit guarantees will be forthcoming. Iraq is eager to maintain good ties to the United States, an attitude intensified by improved relations between Iran and the USSR. [redacted]

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BNL-Atlanta Financing for Iraq

The Atlanta, Georgia branch of the state-owned Banca Nazionale del Lavoro (BNL)--Italy's largest bank--extended $3.2 billion in 2,500 unauthorized letters of credit for Iraq between February 1988 and July 1989. US and Italian authorities have been investigating the scandal since July for violations of banking regulations and tax and customs laws.

Fragmentary reporting indicates BNL-Atlanta disbursed $1.85 billion of the $3.2 billion, including at least $800 million in letters of credit guaranteed by the US Commodity Credit Corporation (CCC). BNL headquarters agreed to release another $550 million in early October, after Iraq threatened to suspend payment to Italian firms if the bank failed to honor its commitments.

BNL-Atlanta's unusual activities included:

-- Exceeding the branch's allowable debt of $500,000 per customer.

-- Charging Baghdad an average 0.2-percent commission instead of the usual 15 percent for a poor credit risk.

-- Financing the letters of credit by borrowing from other banks for 90 to 180 days but allowing Iraq up to five years to repay.

BNL's North American headquarters in New York and the bank's directors in Rome publicly denied knowing about the letters of credit, although a BNL official in Chicago claims he notified New York and Rome several times about the unusual activity in Atlanta, according to press reports. Press reports also indicate a BNL branch in Udine, Italy referred customers exporting to Iraq to the Atlanta branch. Iraqi officials have generally denied knowledge of any wrongdoing, arguing that Baghdad is a victim in the scandal.

Iraq used some BNL credits--at least $600 million, according to British press--to buy military and dual-use technology through various front companies and legitimate firms in Western Europe.

British press says that BNL-Atlanta also financed Iraqi military purchases from Kintex, the Bulgarian armament company.

Impact on Iraq

The suspension of credits from BNL--by far Baghdad's largest source of credits--and disclosure in the British press that Iraq used the credits to acquire military-related technology has almost certainly complicated Baghdad's procurement efforts. We believe that increased Western scrutiny of these activities has at least temporarily impaired Baghdad's ability to acquire such technology. Press coverage and London's

opposition to Iraq's control of a company possessing sensitive technology, for example, led SRC Composites to divest its advanced composites factory, according to press reports. Some other firms in the networks have gone out of business.

The loss of BNL financing has almost certainly slowed civilian reconstruction and development in Iraq. Many US and West European firms supplying goods and services to projects in Iraq were being paid through BNL, Many of these firms have probably suspended business with Iraq until alternate methods of payment--cash, other loans, or barter--are arranged. Financially strapped Baghdad, however, is unable to meet demands by some of these firms for payment in cash, especially for expensive purchases. reporting indicates Iraq has nearly exhausted available credit lines and barter opportunities.

Iraqi Procurement Networks

Baghdad has created complex procurement networks of holding companies in Western Europe to acquire technology for its chemical, biological, nuclear, and ballistic missile development programs. According to British press- -one such network begins in Baghdad with the Al-Arabi Trading Company, which controls the London-based Technology and Development Group, Ltd. (TDG) and another UK firm, TMG Engineering. TDG and its Brussels-based partner, Space Research Corporation, own the Ulster-registered firm Canira Technical Corporation, Ltd. Canira in March established SRC Composites, which acquired access to advanced composite and carbon fiber technology used in aircraft and missile production. In 1987 TMG gained control of Matrix-Churchill, Ltd., the United Kingdom's leading producer of computer-controlled machine tools that can be used in the production of sophisticated armaments.

We believe Iraqi intelligence is directly involved in the activities of many holding companies funnelling technology to Iraq.

Effect on US-Iraqi Relations

For Iraq, any reduction in bilateral commercial ties because of the BNL scandal takes on political significance, which Baghdad--ever paranoid--tends to exaggerate. The fallout from the scandal has strained US-Iraqi relations. Baghdad is seriously concerned that the affair is adversely affecting its economic ties to the United States--the backbone of the bilateral relationship. Iraq is particularly upset that the CCC offered significantly less credit guarantees for FY1990 than Baghdad requested because of negative publicity about the scandal. Iraq fears that any large reduction in CCC credit guarantees would make it more costly and difficult to import agricultural goods and damage its international credit rating.

Several US firms have already been affected by the scandal. press reporting indicate BNL was financing at least $1 billion in sales to Iraq by US firms, including agricultural goods, an automobile plant, an ethylene plant, industrial

machinery, construction materials, and irrigation equipment. Some US suppliers are worried that they will not receive payment on letters of credit that they have not yet submitted to BNL-Atlanta. Many US firms are trying to arrange other means of payment to avoid losing lucrative contracts.

The scandal has contributed to Iraq's perception that the United States is trying to hamstring Baghdad's efforts to promote better political ties. A senior Iraqi official told his US counterpart in early October that Baghdad was unhappy that Washington's decision on CCC credits is linked to the scandal, with which he maintained Iraq had no part. The official indicated this was not a sign that the United States wants to improve relations.

Baghdad is eager to resolve the BNL crisis because harmonious bilateral relations are important to its strategic planning. Iraq believes that the Iranians have not abandoned plans to oust the regime in Baghdad and wants to assure that the superpowers would back Iraq or at least remain neutral during any future hostilities. The Iraqis seek to prevent Washington from favoring Iran so much that Baghdad's interests are threatened. In Iraq's view, the superpowers regard Iran to be of greater importance in the region, and Baghdad is therefore trying to enhance Iraq's political and economic importance to the United States.

Impact on Italy

The BNL affair--in combination with other scandals--has cast a shadow on Prime Minister Andreotti's three-month-old government. Partly to divert attention from the BNL affair, the Socialists and some Christian Democrats are playing up other scandals, including renewed allegations that the Italian military covered up evidence concerning the 1980 crash of an Italian airliner north of Sicily. None of the governing political parties or their factions, however, appears now to believe it can strengthen its relative positions by exploiting the issue.

The scandal has also spotlighted the cost of Italy's longstanding and entrenched spoils system in the state-owned enterprises. Traditionally, appointments to key positions in public-sector companies have been allocated as a measure of party and even factional influence. Under this system, the president and several directors of BNL are members of the Italian Socialist Party, while the executive director usually comes from the Christian Democratic Party. Several backbenchers in parliament quickly denounced the spoils system for not allowing the most competent people to fill public-sector jobs. The attacks, however, have been discounted as political sour grapes, and the system shows no signs of collapse.

In light of the BNL affair, Treasury Minister Carli has renewed his efforts--against admittedly long odds--to enlist support for privatizing state-owned banks and other public-sector corporations. Carli believes the breakdown in supervision at BNL is all too typical of the quality of Italian public-sector banking. In his opinion, privatization would force Italian banks to narrow the current 6-percentage-point spread between interest paid to depositors and that charged to borrowers--a prerequisite if Italian banks are to do well after the EC dismantles capital controls next year.

The discovery of BNL's exposure in Iraq forced the bank to seek funds to boost its capital, which the Bank of Italy already considered too low. If Iraq defaulted, BNL technically would have been bankrupt because the amount of its loans to Iraq exceeded

the bank's capital. In that event, the Bank of Italy and the Treasury Ministry would have been compelled to bail out the bank. Rome was stymied in finding a Socialist-controlled institution to recapitalize the bank by itself, and the government in October finally cobbled together a $1.7 billion package from the Treasury, a state-owned insurance company, and the Social Security Fund, thus maintaining a Socialist majority on the BNL board of directors.

We believe the revelations of BNL's dealings with Iraq--along with other recent scandals--stand in counterpoint to growing Italian self-confidence on the international stage in recent years. After more than three decades of international diffidence, we believe Italian leaders have been pursuing a diplomatic profile more commensurate with their country's international economic role. Italians have felt particular pride because:

-- Italian troops in the Beirut peacekeeping forces had fulfilled their mission as defined by Rome.

-- The Italian decision to accept US cruise missiles played a decisive role in swinging West Germany behind deployment.

-- Their country's GDP had surpassed that of the United Kingdom and possibly France.

In the opinion of almost all Italian press commentators, the BNL affair had a negative impact on Italy's credibility throughout the West. We believe, however, that the setback to Rome's international standing has been substantially less than that portrayed in the Italian press, and we expect the scandal will gradually fade from public view within Italy and will have little lasting impact on the country's perception of its international role.

Outlook

We believe Iraq will work hard to establish new military procurement networks to replace those disclosed by the press and by the US and Italian investigations as part of the fallout from the BNL affair. Baghdad highly values these networks to obtain technology that might otherwise be denied to it if the end user or purpose were revealed. Because of renewed Iraqi efforts and the likely existence of other networks that remain undetected, we do not believe that Iraq's covert procurement efforts will be set back seriously.

The drying up of this major financial source--at least for the next several years--will probably force Iraq to scale back ambitious civilian reconstruction and development plans. Baghdad probably formulated some economic plans under the assumption that BNL-Atlanta would continue to issue letters of credit on its behalf. Iraq will be unable, however, to replace BNL financing any time soon. Most commercial banks and foreign governments are likely to remain unwilling to grant or guarantee significant new credits to Baghdad until it repays more of its $45 billion non-Arab foreign debt--a low priority to Iraq. Furthermore, Iraq has overextended its barter commitments and will probably be reluctant to engage in many more such deals.

The BNL affair will probably have only a minimal impact on Italian-Iraqi relations. The scandal is unlikely to cause more than short-term political friction unless BNL fails to disburse the remaining letters of credit. Even then, Baghdad would probably employ economic--not political--means to punish Rome. Continued Iraqi threats to suspend payment to Italian firms if Rome fails to release the promised BNL credits will almost certainly be effective against the Italians, who have already agreed to release some of the undisbursed credits and have backed down in the past in the face of threats from other countries.

We have detected no sign of flagging Italian interest in Iraq, although we expect that Italian banks will scrutinize export financing and other credits for Baghdad more carefully. The Italians are maintaining existing levels of oil imports from Iraq while still trying to boost exports. Italian-Iraqi relations will continue to be strained, however, by the dispute over the delivery of Italian warships to Iraq, which is unlikely to be resolved any time soon because of Iraqi demands for additional financing for the ships and Iranian threats of retaliation against Italy if the ships are delivered.

Implications for the United States

The BNL scandal is likely to lead to a reduction in US-Iraqi commercial relations, particularly if CCC credit guarantees are decreased. Any loss of CCC credits probably would reduce Iraq's food imports from the United States because Baghdad prefers to buy on credit. Iraq probably would turn to Australia and EC countries--which lost sales when the United States became Iraq's top Western agricultural supplier in 1983--as well as traditional suppliers Turkey and Brazil. Many of these suppliers are already trying to profit from the BNL scandal by boosting agricultural sales to Iraq at US expense. Furthermore, the bank's continued refusal to disburse remaining credits probably would prevent some US firms from implementing contracts with Iraq.

The strain in US-Iraqi political relations caused by the BNL scandal will probably be short-lived, particularly if Baghdad believes additional US credits will be forthcoming after the dust of the investigation settles. Iraq is eager to maintain good ties to the United States, an attitude intensified by improved relations between Iran and the USSR that make Baghdad uneasy. Iraq probably also believes that strained political relations would complicate its efforts to acquire US technology and credits in the future. We anticipate that Iraq will work hard to overcome the current frictions by offering commercial opportunities to the United States and lobbying US business and government officials.

Although the BNL affair embarrassed the Italian Government and banking sector, we do not believe it will not have a major impact on Italian relations with the United States. Rome appears satisfied to date with the cooperation of the US investigating agencies and appreciates the low-key manner in which Washington has reacted. BNL will probably close its Atlanta office and may suffer a loss of business in financing exports for US companies.